Some additional thoughts on the demise of FDI

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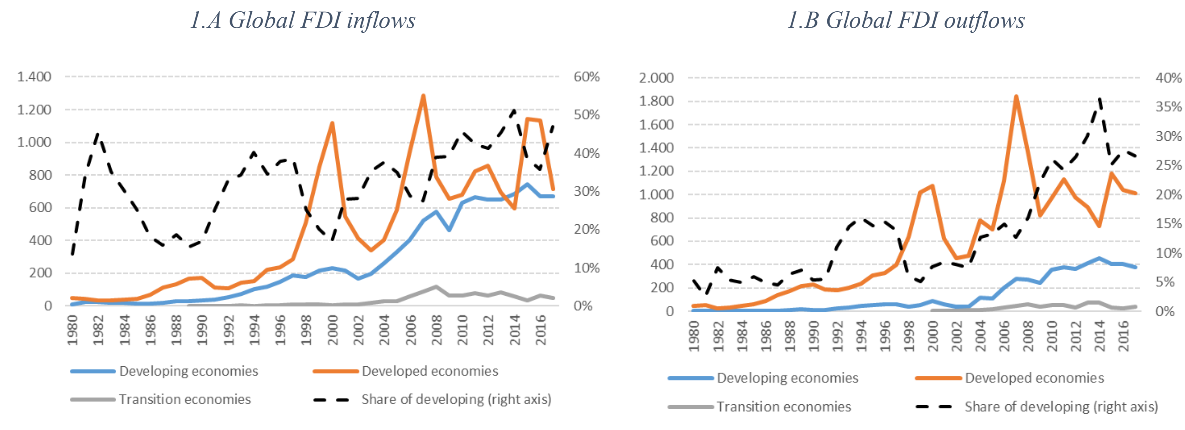
In his contribution to this journal, Ron Davies (2019) discussed some reasons for the explosion of multinational firms' foreign direct investment (FDI) in the 1990s and its more recent flatlining. Despite some economic and political factors slowing down FDI, he argues that especially the role of multinationals in research and development (R&D) will promote their continued role at the forefront of the global economy. As I argue in this comment, additional forces may add to this trend but also shift the global landscape and nature of FDI.

As Onida (2019) already noted in his comment, the "likely possibility that profitable [foreign direct] investment opportunities are starting to dry up" (Davies, 2019) may not be that likely after all; at least not on a global scale. A large fraction of the world's poor live in populous countries with quite auspicious development prospects, notably in Africa, and will not only create a new pool of low-wage laborers but also considerable consumer demand.

FDI may not only shift in geographical focus but also in nature. A considerable part of this potential in developing countries is currently tapped by firms from other developing and emerging economies, notably Chinese outward FDI (see e.g. Abeliansky and Martínez-Zarzoso, 2018). Because emerging-market firms may enjoy a competitive edge in host country environments that are similarly tough as in their home country, the literature has suggested that such familiarity with market imperfections may partly explain the recent increase in 'South-South' FDI.1 The size of 'South-South' FDI stocks, however, is still quite small and much less important than `South-North' FDI. The latter reflects the increasing importance of a knowledge-seeking vertical form of FDI that to date has been somewhat understudied in the literature.[2]

Global FDI in- and outflows by country groups



Source: Schneider and Wacker (2019) based on UNCTAD data (including country classification). Data are flows in billion current US-$.

[1] See the figures as well as the studies by Cuervo-Cazurra and Genc (2008) and Azemar et al. (2012) on the specific channel.

[2] Earlier studies highlighting this FDI channel include Fosuri and Motta (1999) and Bjorvatn and Eckel (2006). Fu et al. (2018) and Amendolagine et al. (2018) provide recent empirical studies. Schneider and Wacker (2019) suggest the presence of vertical motives in `South-North' FDI. Another potential explanation for the increasing `South-North' FDI may be the potential to tap financing sources in the `North'.

Regional cross-border investment promotion amid international investment protectionism. Davies (2019) provides convincing arguments why there might be limits to such knowledge-seeing `South-North' FDI, notably investment restrictions in `sensitive industries.' While this may indeed matter for economies that are Oceans apart, investment liberalization chapters rank prominently in several recent `trade' agreements (see below), some of which are rather regional in nature. We may thus see an increasing trend towards regional multinational corporate structures. Besides from Asia, the European Union will be a region to watch closely in this context. It remains to be seen whether the 'competition camp' can sustain its pushback against politicians favoring `European champions', as recently evidenced by competition commissioner Margrete Vestager's veto against a merger of Alstrom and Siemens. History suggests that such anti-monopolistic efforts tend to be temporary so that we are likely to see another wave of European transnationalisation in the future.

Recent trends in technology favor the concentration of ownership and production. Ron Davies (2019) has already emphasized that multinationals' importance in research & development makes them well suited to lead the way in the global innovation landscape (not least due to tax implications). I want to add that demographic and technological trends will additionally enforce this channel. Take ageing and automation. Innovation in this area may well come from smaller firms that are close to the challenges to be solved. But the fact that challenges such as ageing societies or the quest for new business solutions is common to many countries with high purchasing power calls for their application on a global scale to exploit returns to scale—the textbook argument for horizontal FDI. Moreover, big data and machine learning offer such high global returns to scale in terms of data and knowledge that the only countervailing force against a thrive of a handful of multinationals in this area lies in advanced countries' regulation, like the recent data protection laws in the European Union. They may be apt to slow down or regionally shift multinationals' importance, but not to override it.

Protectionism need not lead to the demise of FDI. The above arguments suggest that policy and regulation will play an important role for the future of multinational corporations. They may be difficult to predict, but even if we run into an era of strengthened regulation and protectionist tendencies, that need not lead to the abdication of multinationals. Onida (2019) already pointed out that trade tariffs may create an argument for more, not less horizontal FDI. Additionally, one may argue that protecting domestic firms creates inefficiencies that lets them lose ground against multinationals in the longer run. This may also be a reason why multinationals were thriving that much in the 1990s: not only did Washington-consensus policies remove investment restrictions but they also exposed previously distorted markets with protected domestic firms to global competition in many countries.

Additionally, the above-mentioned investment chapters and 'investor state dispute settlements' in recent trade agreements will create a loophole for cross-border investment to bypass protectionist ad hoc legislation. If Germany does not want China to invest in 'critical industries', what prevents Chinese firms to set up Singaporean affiliates which then have access to the German market under the investment protection in the EU-Singapore Free Trade Agreement? Such "round-tipping" of FDI is quite popular and will even increase the importance of FDI, creating a potential `Spaghetti bowl' of multinational corporate structures. For example, 81% of all US firms active in the European Union have affiliates in Canada, from where they could enjoy the investment protection benefits of CETA, even without TTIP in place.

Overall, those trends should support the claim that a demise of multinational corporations is unlikely. Will we see their growth rates of the 1990s repeat? As Ron Davies argues, this is unlikely as well. More probably, we will see their nature and regional foci shift, with a lot of new questions emerging for policy, regulation, and research.

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